No. 92-1612

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

SOUTHERN PACIFIC TRANSPORTATION COMPANY, and ST. LOUIS SOUTHWESTERN RAILWAY COMPANY,
Petitioners,

v.

INTERSTATE COMMERCE COMMISSION and UNITED STATES OF AMERICA, *et al.*,
Respondents.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The District Of Columbia Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

The ICC approved a major railroad merger upon the condition that the merging railroads grant to petitioner, a competing railroad, the right to run its trains over portions of the merged system. But for those "trackage rights," which were designed to permit a new, competing transcontinental rail service, the ICC would not have approved the merger. Instead, it would have found the merger to be anticompetitive and not in the public interest. The trackage rights condition was an application of the ICC's merger policy, which was not merely to prevent monopolies, but also to prevent any substantial lessening of competition as a result of a merger. The court of appeals affirmed the ICC's decision approving the merger on the understanding that the ICC would honor and implement that policy in setting the compensation level for the trackage rights. Nevertheless, the ICC departed from its merger policy when it set compensation. The compensation was designed merely to prevent monopoly pricing by the merged system and not to prevent a substantial lessening of competition. The question presented is as follows:

Does the requirement of *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983), that an agency acknowledge and sufficiently explain departures from prior policy, apply, and is it satisfied, when the ICC, in implementing a critical procompetitive condition of a rail merger, departs from the merger policy underlying the condition, and does not acknowledge or explain the departure?

LIST OF PARTIES AND RULE 29.1 LIST

Southern Pacific Transportation Company and St. Louis Southwestern Railway Company, petitioners here, and Union Pacific Corporation, Union Pacific Railroad Company, and Missouri Pacific Railroad Company, were petitioners or intervenor-respondents in consolidated cases in the court of appeals. The Interstate Commerce Commission and the United States of America were respondents in the consolidated cases in the court of appeals.

A list of parent companies and subsidiaries (except wholly owned subsidiaries) of Southern Pacific Transportation Company and St. Louis Southwestern Railway Company (which itself is a subsidiary of Southern Pacific Transportation Company) is as follows:

Parent companies:

The Anschutz Corporation
Rio Grande Industries, Inc.
SPTC Holding, Inc.

Subsidiaries:

Alton & Southern Ry. Co.
Arkansas & Memphis Ry. Bridge and Terminal Co.
Central California Traction Co.
Harbor Belt Line R.R. (nonincorporated joint agency)
Kansas City Terminal Ry. Co.
Ogden Union Ry. & Depot Co.
Portland Terminal R.R. Co.
Portland Traction Co.
Southern Illinois and Missouri Bridge Co.
Sunset Ry. Co.
Terminal R.R. Association of St. Louis
TTX Co.

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On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The District Of Columbia Circuit

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PETITION FOR A WRIT

Petitioners Southern Pacific Transportation Company and St. Louis Southwestern Railway Company (collectively, "SP") hereby request that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia Circuit, filed October 30, 1992.

OPINIONS BELOW

The opinion of the court of appeals is not reported and is reprinted in the Appendix hereto ("App.") at

1a-3a. The orders of the court of appeals denying SP's petition for rehearing and suggestion of rehearing *en banc* are not reported and are reprinted at App. 4a and 5a, respectively.

The opinions of the Interstate Commerce Commission ("ICC") are listed in the margin, and are reprinted beginning at App. 7a.[1]

JURISDICTION

The judgment of the court of appeals was entered on October 30, 1992 (App. 1a). On January 6, 1993, the court of appeals denied SP's timely request for a rehearing and suggestion for rehearing *en banc*. This petition is filed within 90 days of the order denying rehearing.

SP invokes the jurisdiction of this Court under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

This case arises under the Interstate Commerce Act. In the rulings at issue, the ICC purported to implement a condition previously imposed by it in a rail merger proceeding. The pertinent statutory provisions are at 49 U.S.C. §§ 10101a, 10704(a)(2), 10709(a), 11341(a), 11343(a), 11344(b)(1)(E), 11344(c). These provisions are reprinted at App. 200a-205a.

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[1] *St. Louis S.W. Ry.—Trackage Rights Over Mo. Pac. R.R.—Kansas City to St. Louis*, 1 I.C.C.2d 776 (1984) ("*Compensation I*"); 4 I.C.C.2d 668 (1987) ("*Compensation II*"); 5 I.C.C.2d 525 (1989) ("*Compensation III*"); 8 I.C.C.2d 80 (1991) ("*Compensation IV*"); 8 I.C.C.2d 213 (1991) ("*Compensation V*").

STATEMENT OF THE CASE

A. Basis for Jurisdiction Below

The court of appeals had jurisdiction under 28 U.S.C. §§ 2321 and 2342 to review the final orders of the ICC in this case.

B. The ICC's Merger Authority

Railroads seeking to merge with each other require the approval of the ICC.[2] Once the ICC approves a merger, the merging carriers are exempt from the antitrust laws to the extent necessary to carry out the approved transaction.

Railroad competition is a central element in the ICC's evaluation of merger applications. *Union Pac. Corp.—Control—Missouri Pac. Corp.*, 366 I.C.C. 462, 501-02 (1982) ("*UP-MP Merger*"), *aff'd sub nom. Southern Pac. Transp. Co. v. ICC*, 736 F.2d 709 (D.C. Cir. 1984), *cert. denied sub nom. Brotherhood of Maintenance of Way Employees v. United States*, 469 U.S. 1208 (1985). For transactions involving two or more large railroads ("Class I railroads"), the ICC is required to apply a public interest standard, which includes among its enumerated elements whether the proposed transaction "would have an adverse effect on competition among rail carriers in the affected region." Section 11344(b)(1)(E).[3] In the National Rail

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[2] The requirement for ICC approval applies to all forms of common control, including consolidations short of full merger. *See* 49 U.S.C. § 11343 (1988). For convenience, SP will refer to all control transactions subject to the prior approval requirement as mergers.

[3] Hereafter, all references to statutory sections are to Title 49 of the U.S. Code (1988), unless otherwise indicated.

Transportation Policy enacted as part of the Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895, Congress declared that the policy of the United States is "to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail." Section 10101a(1). This policy has "increased the need to identify carefully any anticompetitive effects" of a proposed rail merger, which are then balanced against anticipated benefits. *UP-MP Merger*, 366 I.C.C. at 502.[4]

Through Section 7 of the Clayton Act, 15 U.S.C. § 18 (1988), Congress has required that the anticompetitive consequences of mergers be prevented in their incipiency. *United States v. E.I. du Pont de Nemours & Co.*, 353 U.S. 586, 597 (1957). The ICC considers that policy of Section 7 to be an element of the public interest standard governing major rail mergers. *See UP-MP Merger*, 366 I.C.C. at 501. When the ICC assesses potential anticompetitive effects of rail mergers, it utilizes the principles of Section 7. *See id.* at 502-506.

Section 7 on its face distinguishes a substantial lessening of competition from creation of monopoly.[5] So

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[4] Although the ICC does not enforce the antitrust laws as such, *McLean Trucking Co. v. United States*, 321 U.S. 67, 79-80 (1944), competition is "significant chiefly as it aids in the attainment of the objectives of the national transportation policy," *id.* at 85-86. National policy at the time of *McLean Trucking* did not give the emphasis to competition that is now contained in the National Rail Transportation Policy. *Compare id.* at 82-83 *with* 49 U.S.C. § 10101a(1).

[5] Section 7 states that mergers whose effect "may be substantially to lessen competition, or to tend to create a monopoly"

does the ICC's merger policy. If a proposed rail merger would be likely to result in a substantial *lessening* of competition, even if the remaining competition would be sufficient to prevent the merged system from obtaining monopoly power, the ICC will not approve the merger unless it can design procompetitive conditions to offset the lessening in competition.[6] It will then approve the merger subject to these conditions. *See, e.g., Southern Pac. Transp. Co. v. ICC*, 736 F.2d 708, 712 (D.C. Cir. 1984) ("*SPT*"), *cert. denied sub nom. Brotherhood of Maintenance of Way Employees v. United States*, 469 U.S. 1208 (1985). The ICC's conditioning authority is explicit (Section 11344(c)), and is "not limited to conditions proposed or favored by the carriers." *New York Cent. Sec. Corp. v. United States*, 287 U.S. 12, 28 (1932). If a condition is necessary to render a proposed merger in the public interest, the ICC may not approve the merger without the condition. *Baltimore & O. R.R. v. United States*, 386 U.S. 372, 388-90 (1967).

A frequently imposed condition is that the merging railroads allow one or more competing railroads to run trains over designated portions of the merged system. Through these "trackage rights," the ICC is

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are prohibited. *See United States v. E. I. du Pont de Nemours & Co.*, 353 U.S. at 589 (distinguishing prevention of monopoly from prevention of substantial lessening).

[6] Anticompetitive effects may occur because the merging railroads have parallel lines, and, therefore, are direct competitors. Where the two railroads are end-to-end, meeting at commonly served points, the merger might result in the vertical foreclosure of competing railroads, or in a reduction in competition for movements between the commonly served points and other origins and destinations, so-called "source" competition.

able to create new rail routes, or augment existing routes, to compete with the merged system.

Under a trackage rights condition, the new competition is not based on the provision of alternate railroad facilities. Instead, the new competitor uses the track of the merged system. The merged system supplies track space both to its own shippers and to the trackage rights grantees. The merged system is the grantor and the potential competitor is the grantee. For this reason, the compensation paid for the trackage rights is a critical determinant of the tenant railroad's ability to provide the level of competition that would otherwise be lessened by the merger.

C. The Union Pacific Merger

In 1982, three major railroads, the Union Pacific Railroad ("UPRR"), the Western Pacific Railroad ("WP"), and the Missouri Pacific Railroad ("MP") (collectively, "UP") received the approval of the ICC to merge. The ICC found that the merger, as proposed, was not in the public interest because it would have had serious anticompetitive effects. The ICC examined "both the parallel and end-to-end effects (roughly analogous to horizontal and vertical effects, respectively . . .)." *SPT*, 736 F.2d at 718. This examination showed that the merger would have "significant adverse competitive effect" in the central corridor—the rail corridor across the center of the country between the West Coast and the Midwest, via interchanges in Utah and Colorado. *UP-MP Merger*, 366 I.C.C. at 533. UP's post-merger market share, for example, would have been "extremely high by conventional antitrust standards." *Id.* at 512. The ICC said that the "substantial lessening of competition" in the central corridor "must be redressed if

we are to approve the proposed transactions." *Id.* at 525.

The ICC believed that it could redress the anticompetitive effects by approving the merger subject to certain procompetitive conditions, and did so. The applicant railroads accepted the conditions and consummated the merger. The result was to create the second largest rail system in the United States, and to change the face of rail competition in the West.

The ICC's key condition was that the UP grant SP and another railroad, the Denver and Rio Grande Western ("DRGW"), the right to run their trains over certain portions of the merged UP. Those trackage rights, in conjunction with existing routes of SP and DRGW, would create a new rail route in the central corridor to compete with UP.[7] These trackage rights, the ICC said, would "*offset* reductions in competition" and "*preserve* the competitive balance." *Id.* at 587, 589 (emphasis added). The trackage rights were thus designed to prevent any substantial lessening of competition, in accordance with the ICC's merger policy.

The ICC recognized, however, that the effectiveness of the trackage rights depended heavily upon the compensation that SP and DRGW would pay to UP for the exercise of the rights. SP and DRGW would be

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[7] SP owned lines between Oakland, California and Salt Lake City. At Salt Lake City, SP could interchange with DRGW, which owned lines running between there and Pueblo, Colorado, south of Denver. From Pueblo to St. Louis, the new route would consist of trackage rights over MP, one of the merging railroads. Between Pueblo and Kansas City, DRGW received the trackage rights; between Kansas City and St. Louis, SP received the trackage rights. The trackage rights apply to both eastbound and westbound trains.

competing with UP over UP track. The more that SP was required to pay UP, the less margin it would have to compete vigorously with UP for the same business. Whether the anticompetitive potential of the merger would be frustrated depended, the ICC said, on "the ability of DRGW and SP to fashion effective competitive responses to the consolidated system." *Id.* at 514. The public interest required the preservation of competitive balance; competitive balance required the trackage rights; and the "key to the success of the [trackage rights] conditions lies in the terms of compensation . . . ." *Compensation I*, 1 I.C.C.2d at 779, App. 12a.

Although compensation was the key to the competitive restraint afforded by the trackage rights, the ICC did not resolve the issue of compensation in its decision approving the UP merger. Instead, it stated general compensation principles that it would apply in the event the parties failed to agree on compensation terms that were consistent with the competitive purpose of the trackage rights.

SP argued on judicial review of the ICC's *UP-MP Merger* decision that, because compensation was the critical issue, proper judicial review was impossible unless and until compensation had been determined. The court of appeals nevertheless affirmed the ICC's conditioned approval of the UP merger. The court found that the ICC had "specifically provided that the [compensation] terms . . . *must be such as to make the new transcontinental corridor (SP/DRGW) competitive* with the merged system." *SPT*, 736 F.2d at 721 (emphasis added). The court added that

> we trust the Commission to *ensure* that the compensation terms will not defeat the pur-

> pose of the trackage rights. The ICC has in fact *guaranteed* that it will see to the proper functioning of the trackage rights.

Id. (emphasis added). The court affirmed the ICC's conclusion that, "[a]s conditioned," the "public benefits from the consolidations outweighed their negative effects." *Id.* at 712.

Thereafter, negotiations over compensation failed and the ICC began the compensation proceeding that gave rise to the instant controversy.[8]

D. The Course of Proceedings and Disposition Below

1. The issue in the compensation proceeding

There was no question in the compensation proceeding that SP should reimburse UP for costs that SP causes by reason of its use of the line between Kansas City and St. Louis, as well as for an equitable share of UP's out-of-pocket costs of maintaining and operating the line. The controversy concerned an al-

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[8] During the pendency of the compensation proceeding, SP has been operating under an interim agreement with UP, under which SP pays UP a certain monthly fee for the trackage rights. The ICC held that in order to ensure that UP is made "whole" in the event the amount eventually owing is larger than the monthly payments, SP must pay compound interest on the difference. *Compensation I*, 1 I.C.C.2d at 792, 805. DRGW has been operating under a settlement with UP entered into shortly after the compensation proceeding began. In 1988, SP and DRGW themselves came under common control. That did not reduce the importance of an SP-DRGW route to compete with UP in the central corridor, nor did it change the fact that the trackage rights were essential to that route. *See Rio Grande Indus., Inc.—Control—Southern Pac. Transp. Co.*, 4 I.C.C.2d 834, 908 (1988), *aff'd sub nom. Kansas City S. Indus., Inc. v. ICC*, 902 F.2d 423 (5th Cir. 1990) ("*SP-DRGW*").

leged tension between two basic regulatory goals. One goal was to compensate UP for the cost of the equity capital invested in the line (which the parties and ICC referred to as the "rental" component of trackage rights compensation). As a matter of principle, UP should have an opportunity, when the market allowed, to become "revenue adequate" by earning the "cost of capital"—the returns that investors must expect before putting capital into an enterprise.[9] Cost-causation was not a guide on this issue, because the amount of capital UP invested to acquire the line was not altered by SP's usage. UP's out-of-pocket expenditures were not a guide because the return required by equity investors (unlike that required by lenders) is not a cash obligation.

The other goal was the procompetitive purpose of the trackage rights themselves. SP argued that rental for the trackage rights had to be set so that efficiency was the determinant of competitive success. If compensation were set properly, UP would gain traffic from SP only when UP was the more efficient carrier for the movement. SP would retain or gain traffic for which it was the more efficient carrier.[10] If SP

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[9] The ICC determines the railroad industry cost of capital on an annual basis. *See, e.g., Standards For Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981), *aff'd sub nom. Bessemer & Lake Erie R.R. v. ICC*, 691 F.2d 1104 (3d Cir. 1982), *cert. denied*, 462 U.S. 1110 (1983); *Railroad Revenue Adequacy—1991 Determination*, 8 I.C.C.2d 666 (1992).

[10] Thus, SP was arguing for the protection of competition, not the protection of a competitor. The latter occurs when a nonmerging carrier argues that the ICC should impose conditions that would protect its revenues *regardless* of whether it is the more efficient carrier. SP's argument is that efficiency should be the determining factor.

was not able to do so because of the rental, UP would gain traffic not because it was more efficient but because it had merged. That result would be the opposite of the merger policy that the trackage rights were designed to implement.

The issue in the compensation proceeding arose because, before the merger, MP was earning only what the transportation market allowed it to earn, and the transportation market did not allow it to charge its shippers the cost of capital. SP argued that, if, after the merger, UP was charging SP the cost of capital, the increase would not be due to any change in MP's efficiency, or to a change in the transportation market. It would be due solely to the fact that MP merged and the ICC *set* UP's compensation at the cost of capital, a level that is not determined by the transportation market. UP would be charging SP more than UP was charging its shippers for use of the same line. If SP were paying UP the cost of capital but shippers using UP were not required to pay at that level, SP would be unable to compete effectively with UP.

SP argued that the goals of competition and revenue adequacy would be properly reconciled if UP could earn the cost of capital for use of its tracks from SP whenever UP was charging shippers the same amount. There was no need, therefore, to lessen competition in the interest of UP's revenue adequacy. So long as UP charged all users of its track the same for track rental, competition on the basis of operating costs and service would continue to prevail, and UP would be able to earn the cost of capital whenever the market allowed it to charge its shippers the cost of capital.[11]

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[11] The only economic testimony concerning SP's proposal was

2. The ICC's decisions in the compensation proceeding

The Commission issued its first decision in the compensation proceeding shortly after the court of appeals had affirmed its conditioned approval of the UP merger. The expectation of the court with respect to compensation, expressed as the ICC's "guarantee" of the procompetitive functioning of the trackage rights, was still freshly in mind. The ICC designed its first decision around the procompetitive goal: "[W]e are attempting to place the tenant [SP/DRGW] *in precisely* the position of the owning road [UP]." *Compensation I*, 1 I.C.C.2d at 786, App. 24a (emphasis added). The "tenant *must be able to operate competitively*." Id., App. 25a (emphasis added.)

Subsequently, the ICC determined that its decision in *Compensation I* was flawed. In *Compensation I*, the ICC had set SP's rental at a level that would not have varied with changes in the railroad cost of capital. The rental might have been below the cost of capital in some years, and above it in others. The ICC concluded in *Compensation II* that if SP paid rental at that prescribed level, the ICC might be "perpetuating" an insufficient return for UP. *Compensation II*, 4 I.C.C.2d at 682 App. 84a-85a. The ICC's concern was that UP might be unable to attain revenue adequacy even in years when market conditions would allow it to charge its shippers the cost of capital, because SP would be paying a lesser amount.

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in support of the proposal. This testimony was from the two economists who had been *UP's* witnesses on the compensation issue in the *UP-MP Merger* proceeding. *See* ICC Finance Docket No. 30000 (Sub-No. 16), SP Petition to Reconsider and Reopen, Attachment A, Baumol-Willig Verified Statement (Sept. 24, 1991).

As a way to fulfill the goals both of revenue adequacy and competition, SP proposed that rental be set at UP's actual return on investment ("ROI") each year. If market conditions during a year allowed UP to charge its shippers the cost of capital (so that its ROI was the same as the cost of capital), then SP would pay its usage share of the cost of capital. If UP's ROI was less than the cost of capital, SP would pay its usage share of the ROI. In either case, SP would be paying UP the same amount for track space as UP's shippers were paying for track space on the same line.

In its second compensation decision, however, the ICC decided that SP should pay UP a usage share of the cost of capital *regardless* of whether UP was actually charging its shippers the cost of capital. *Id.* This decision created the cost disadvantage to SP that precipitated SP's appeal. In years when UP was not earning the cost of capital from its shippers, SP would be paying UP more than UP's shippers were paying for use of UP's track.[12]

The ICC created a dichotomy between preserving competition and allowing UP the opportunity to earn its cost of capital. The ICC never showed why the dichotomy existed under SP's proposal or how, with a handicap in the rental, SP would be able to retain or gain traffic for which it was the more efficient carrier.[13]

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[12] In no year since the UP-MP merger has UP earned the cost of capital.

[13] SP pointed out that there cannot be any differences in the efficiency of SP and UP that flow from the location or characteristics of the line they are using between Kansas City and

The ICC's refusal to address the fact that there was no necessary dichotomy led it ultimately to assert that SP had not shown the "*relevance*" of evidence showing the effect of the compensation method on SP's "*ability* or willingness to operate the trackage rights." *Compensation IV*, 8 I.C.C.2d at 95, App. 164a (emphasis added). The ICC did not attempt to show how this statement was consistent with its earlier guarantee to the court of appeals that it would set compensation so as to ensure the proper competitive functioning of the trackage rights.

The ICC's insistence that there was a dichotomy between the goal of UP's opportunity for revenue adequacy and the goal of preventing a lessening of competition led the ICC eventually to abandon the latter goal entirely. It was enough that SP would be able "to offer an effective competitive alternative" under *one* set of conditions: "*if* UP were to engage in *monopolistic* pricing practices." *Id.* at 86, App. 152a (emphasis added); *see also id.* at 87, App. 153a. "We intended that the formula would produce an interest rental payment low enough to achieve this purpose, but no lower." *Id.* at 87. The ICC did not explain how a rental intended to do no more than prevent *monopoly* pricing by the merged UP system would prevent post-merger *lessening* of competition and resultant price increases *short* of monopoly levels. A dissenting Commissioner characterized this reasoning

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St. Louis, since both are using the same line. Differences can arise only in the efficiency with which the two railroads move traffic over the line, with respect to operating costs (*e.g.*, fuel, labor, equipment utilization, assembling and other handling of trains), or the quality of the services they offer (*e.g.*, scheduling, accountability, car availability).

as containing a "basic flaw" and as "inconsistent with the Commission's original intent in granting the trackage rights." *Id.* at 111, App. 184a.

3. The proceeding in the court of appeals

Both SP and UP filed timely petitions for judicial review of the ICC's decision.[14] The ICC did not attempt to show how preventing any substantial lessening of competition and merely preventing monopoly pricing were the same policy.[15] Nor did the court of appeals address the issue. In its brief opinion denying both petitions, the court acknowledged that the ICC "did not fully explain why the petitioners' suggested approaches were inferior to its own." Slip op. at 2, App. 3a. SP invoked *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983) ("*State Farm*"), as requiring the ICC to explain its change of policy, from prevention of substantial lessening to prevention of monopoly. But the court of appeals treated the issue solely as a matter of deference. It did not recognize the inadequacy of the agency's explanation as a legal issue. Instead, the court said that the petitioners had not demonstrated

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[14] UP insisted that the ICC should have created an even greater cost disadvantage to SP by valuing the line at approximately six times the value that the ICC had assigned to it.

[15] SP pointed out to the court of appeals the position of the Department of Justice that the ICC should not approve a merger if proposed procompetitive conditions "would not *maintain existing price and service competition.*" D.C. Cir. No. 88-1186, Brief of Petitioner Southern Pacific Transportation Company and St. Louis Southwestern Railway Company at 27 n.6 (July 1, 1992), quoting *Santa Fe S. Pac. Corp.—Control—Southern Pac. Transp. Co.*, 3 I.C.C.2d 926, 931 (1987) (emphasis added).

"*clearly and convincingly* a fatal flaw" in the ICC's action; it is not enough for a petitioner "merely to put forth an acceptable alternative." Slip op. at 2, App. 3a. (citation omitted) (emphasis in original).

SP timely filed a petition for rehearing and suggestion for rehearing *en banc*. The court of appeals denied both requests on January 6, 1993.

REASONS FOR GRANTING THE WRIT

This case presents an important question concerning the application of *State Farm*. Petitioners argued below that the ICC initially applied its merger policy when it approved the UP merger subject to certain critical procompetitive conditions; then *abandoned* that policy when it implemented the conditions in a subsequent proceeding; and *neither acknowledged nor explained* the abandonment. The court of appeals acknowledged that the ICC had not explained why its compensation method was superior to SP's, but declined to remand to the agency for further explanation. The court of appeals erroneously failed to require the ICC to address the departure from established policy, and to explain any departure adequately, as required by *State Farm*.

This case is the ICC's leading case on the compensation issue. It bears on the ICC's entire approach to rail competition and the ongoing rationalization of rail facilities through mergers and other consolidations in accordance with congressional intent. It is not a case about an arcane aspect of cost-accounting or rate theory that Congress has entrusted to the ICC's discretion. It is about whether the ICC, having required trackage rights as an indispensable application of its procompetitive rail merger policy, should

have been held to the *State Farm* standard of explanation when it appeared to abandon that merger policy during the crucial step of setting compensation for the trackage rights, without explaining or even acknowledging the reversal.

A.

The application of *State Farm* to the ICC's implementation of rail merger conditions designed to offset anticompetitive effects is essential to the proper administration of the rail merger provisions of the Interstate Commerce Act. Rail mergers and other forms of consolidation play a key role in rationalizing the rail network and realizing statutory objectives of efficiency and sound economic conditions in the industry. *McLean Trucking*, 321 U.S. at 81.[16] To the extent those objectives are realized, the industry is enabled to attract capital and avoid the type of disinvestment that led to the collapse of the Northeastern railroads after World War II.

The ICC, however, cannot itself initiate or order such structural changes, which are left under the Act to private initiative. Railroads can and do propose mergers that will benefit them, and increase efficiency, but at the price of serious anticompetitive effects. The ICC recognized in the *UP-MP Merger* that the competitive freedoms afforded by recent legislation had made it "easier to exert or abuse market power gained as a result of consolidation." *UP-MP*

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[16] For example, rail mergers between railroads that are end-to-end can bring increased flexibility in the pricing of through movements and in negotiating with shippers; the elimination of redundant facilities and overhead; and improved equipment utilization and accountability to shippers.

Merger, 366 I.C.C. at 502. Trackage rights and other forms of mitigating conditions play an essential role in enabling the ICC to refashion merger proposals, so that the anticompetitive effects are offset while the enhanced efficiencies are largely maintained, thereby bringing about *net* public benefits.[17]

As this case illustrates, conditions are meaningless unless they are implemented to achieve their procompetitive purpose. When the ICC gets down to particulars and implements procompetitive conditions, it must exercise its expertise and discretion with fidelity to the procompetitive purpose, and rely upon appropriate reasons. Reviewing courts must be able to determine that the ICC did so. *State Farm* must be applied when the ICC's implementation of a condition appears to depart from the policy that led to the imposition of the condition in the first place.

The problem is a general one, because the potential for departure is *inherent* where the ICC imposes conditions on an otherwise anticompetitive rail merger. The analysis that leads the ICC to identify anticompetitive effects and fashion offsetting conditions is an

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[17] In addition to the trackage rights conditions imposed in the *UP-MP Merger*, *see, e.g.*, *Union Pac. Corp.—Control—Missouri-Kansas-Texas R.R.*, 4 I.C.C.2d 409, 531, ¶ 27 (1988), *pet. for review dismissed*, 883 F.2d 1079 (D.C. Cir. 1989); *CSX Corp.—Control—Chessie Sys., Inc.*, 363 I.C.C. 521, 602, ¶¶ 10 & 12, 603, ¶¶ 27 & 31 (1980), *aff'd sub nom. Brotherhood of Maintenance of Way Employees v. ICC*, 698 F.2d 315 (7th Cir. 1983). In the one major rail merger case in the 1980's where the ICC withheld approval, it did so because it could not satisfactorily design trackage rights or other conditions to offset the anticompetitive effects it found. *See Santa Fe S. Pac. Corp.—Control—Southern Pac. Transp. Co.*, 2 I.C.C.2d 709 (1986), *reconsideration denied*, 3 I.C.C.2d 926 (1987).

antitrust type of analysis. The implementation of conditions does not flow automatically from this analysis. To the contrary, determining the particulars of implementation can involve distinct considerations of a very different type. Certainly that is true with respect to determining compensation. *State Farm* has a particularly important role in such circumstances.

The *State Farm* requirement is also essential to the integrity of judicial review. Trackage rights imposed as a condition of the ICC's approval of a merger are always procompetitive *in concept*. Their very rationale is to offset what would otherwise be the anticompetitive consequences of a proposed merger. If a reviewing court assumes that the trackage rights terms will be defined and implemented by the ICC so as to achieve their procompetitive purpose, a merger conditioned on trackage rights will generally survive judicial review. But a reviewing court can justify this assumption only if it can also assume that it will be able to determine what the agency did with respect to the actual terms for implementation, in particular, compensation.[18]

If a reviewing court accepts less than a full explanation of the reasons for the ICC's method of implementing *nominally* procompetitive conditions, the

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[18] In this case, the court that affirmed the ICC's conditioned approval of the UP merger explicitly assumed that the ICC would set compensation so as to implement the procompetitive purpose of the trackage rights. And the court that reviewed the ICC's compensation decision declined to require a full explanation by the ICC of its compensation decision. The issue is the same, however, whether there is bifurcated review or whether the ICC determines implementation as part of the merger proceeding itself.

ICC's approvals of seriously anticompetitive mergers will be affirmed on unrealistic judicial expectations about the degree to which such conditions will offset anticompetitive effects. Outcomes resting on such judicial misconceptions impair both the proper administration of the Act and the integrity of judicial review. There is only one way to avoid this result. The ICC must apply the same policy in implementing conditions as it uses to impose them initially, or provide a full explanation for any departure. *State Farm* must be applied to ICC implementation decisions that appear to abandon the policy on which the merger condition rests.

B.

The predicate for a *State Farm* issue is, of course, that the agency departed from or appeared to depart from a policy, without acknowledgment or adequate explanation. As petitioners have pointed out, the potential for departure is inherent in compensation decisions, because considerations come into play in determining compensation that are not a part of the antitrust type of analysis that leads to the imposition of a condition in the first place. The predicate is in fact present in this case. The ICC departed from its merger policy and failed to acknowledge that it had done so, but the court of appeals declined to require a full explanation.

When it approved the UP merger, the ICC had required the trackage rights as an application of its merger policy, and the court of appeals had affirmed the ICC's decision. Therefore, SP argued, compensation for the trackage rights had to be consistent with that same policy, which provided a clear answer,

and the only answer, to the question of the proper rental.

Under the ICC's merger policy, the extent of inter-railroad competition existing before the merger is a baseline for assessing the net change in consumer welfare from a proposed merger. Following Section 7 of the Clayton Act and the National Rail Transportation Policy (Section 10101a), the ICC does not allow mergers to cause a significant lessening of inter-railroad competition, *even if* after the merger the remaining competition would be sufficiently effective to deny monopoly power to the merged system.

The trackage rights condition furthered this policy. It was designed to "*offset* reductions in competition" and "*preserve* the competitive balance." 366 I.C.C. at 586-87, 589 (emphasis added). The court of appeals that affirmed the ICC's conditioned approval of the UP merger understood the trackage rights in the same way. The court emphasized that the Commission "*carefully tailored* the trackage rights to *match* anticompetitive effects." *SPT*, 736 F.2d at 720 (emphasis added).

Ultimately, however, the ICC disavowed these purposes. In its final articulation, the ICC claimed that the trackage rights had been intended *only* to enable SP to offer a competitive alternative "*if* UP were to engage in *monopolistic* pricing practices." *Compensation IV*, 8 I.C.C.2d at 86, App. 152a. (emphasis added). The rental paid by SP, the ICC said, had to be "low enough to achieve this purpose, but no lower." *Id.* at 87, App. 153a. This decision assured that UP would not face effective competition until its prices rose from the pre-merger level to the monopoly level. Again, however, the ICC made no attempt to

justify this earnings increase in terms of its merger policy. Because the ICC's policy is to prevent any substantial lessening of competition, an essential element of the policy is that any shifts of traffic to the merged system must be the result of increased efficiency and not increased market power. "Revenue transfers [to merged carriers] which result from *reduced* competition, *or* the ability of a carrier to exact monopoly profits, reflect private benefits which result in harm to the public." *SP-DRGW*, 4 I.C.C.2d at 875 (emphasis added).

When the ICC approved the UP merger subject to the trackage rights condition, it could have said "we are going to allow competition in the central transcontinental corridor to diminish to the point at which UP might be able to charge monopoly prices, and we impose the trackage rights condition, not to prevent any substantial lessening of competition, but only to prevent monopoly prices." That would have been a different decision from the one that the ICC rendered and the court of appeals affirmed.

The ICC, however, did not even acknowledge the difference, much less attempt to explain how compensation that did no more than prevent monopoly pricing would prevent a *lessening* of competition *short* of a deterioration that left UP with monopoly power. The ICC offered not a word of explanation as to how this prevention-of-monopoly pricing rationale could be squared with the policy of preventing any substantial lessening of competition. *See Compensation IV*, 8 I.C.C.2d at 86, 87, App. 152a, 153a.

In the final analysis, by requiring SP to pay UP a usage share of the cost of capital even when UP's ROI—the amount it was charging its own shippers—

is less than the cost of capital, the ICC created a competitive handicap for SP that did not relate to efficiency. When it rejected SP's position, the ICC thus reversed its merger policy of preventing any substantial lessening of competition, which means protecting the opportunity of the more efficient carrier to retain or gain traffic.

The court of appeals recognized that the ICC had not explained why its choice of compensation was superior to SP's, but affirmed on grounds of deference to the agency. Deference, however, is due only *after* the agency has satisfied *State Farm*. *Cf. Seldovia Native Ass'n, Inc. v. Lujan*, 904 F.2d 1335, 1346 (9th Cir. 1990). Without adequate explanation, there is nothing to which the court may defer. This Court should clarify the application and requirements of *State Farm*.

CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of certiorari.

Respectfully submitted,

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